

For release on delivery
11:15 am CST (12:15 pm EST)
March 30, 1993

Detecting and Eliminating Possible
Discrimination in Financial Institutions

Address by

John P. LaWare

to

The Bank Administration Institute's

1993 Bank Audit, Compliance

and Security Conferences

Dallas, Texas

March 30, 1993

I appreciate the opportunity to speak to you today about a topic that is receiving much attention from community groups, the Congress, and the regulators. That topic is discrimination in mortgage lending--or, more specifically, as your program notes, "detecting discrimination in mortgage lending."

I can't imagine a topic that embodies more controversy and affects more people than this one. This nation was founded on the idea that all of us have certain rights and certain freedoms. While the Pilgrims may not have had home ownership at the top of their list, home ownership certainly is part of the American dream today.

Lately, mortgage lending discrimination has become a leading attention getter in the press. Numerous magazine and newspaper articles, and even television programs, have focused on this issue. In turn, these articles have raised the public's perception of mortgage discrimination as a national problem. And, lately, the Congress has held several hearings on this issue. I don't think I have to tell you what happens when the Congress and the public perceive a problem that is not being adequately addressed. More regulation is usually the solution that first comes to mind.

More regulation, however, does not have to be the solution. In fact, I'm not sure that more regulation will solve the problem. I believe that it is up to us, regulators and lenders alike to find the solution. We must take a hard look at what we

are doing to eradicate discriminatory practices. We have to start now. I can assure you that if banks and regulators do not take action, then the Congress will take it for us. I can also assure you that any action the Congress may mandate will probably be more expensive in the long run than action you yourself design for your institution.

The conference brochure indicates that my presentation will focus on HMDA data as a means of detecting mortgage discrimination. Frankly, I don't believe the HMDA data tell the whole story, or even most of it. Taken alone, these data will neither prove nor disprove discrimination. The data will, however, point out areas for further investigation. Going beyond the data is the challenge for all of us.

First, let me say that I certainly do not presume to have all the answers. I believe, however, that there are things that compliance and audit professionals can do to eliminate discrimination in your institution. Many of them cost little to implement, but will yield dividends in the future.

As I see it, there are three main areas or ideas. The first involves setting up a fair lending framework within your bank. Once the initial framework is established, reviewing what your bank is actually doing and taking steps to correct identified problems, should follow naturally.

Detecting and eliminating discrimination, whether intentional or not, takes special effort. Before you can achieve

this goal, you have to make the message loud and clear that discrimination will not be tolerated. You have to make a statement and it should come from the "top of the house". Does your bank have a mission statement that incorporates fair treatment to all applicants? Do all of your employees, from the teller in the lobby to the telephone operator in the back room, know about the bank's position on discrimination? Do your policies and procedures make it clear that discrimination will not be tolerated?

Last month I testified on behalf of the Federal Financial Institutions Examination Council, or the FFIEC, before the Senate Banking subcommittee. My testimony focused on what the agencies are doing to combat and eliminate discrimination in mortgage lending. In that testimony, I enunciated a mission statement of sorts for the Federal Reserve's position on mortgage discrimination. I'd like to read it you.

"Parity in how applications are considered, without regard to race, sex or other prohibited bases, is absolutely essential in our country. Let no one have any misunderstanding on the point. Racial discrimination, no matter how subtle and whether intended or not, cannot be tolerated. Simply stated, excluding any segment of our society from fundamental economic opportunities, such as home ownership and equal access to credit, is morally repugnant and illegal. Moreover, it robs the lending

industry and our economy of growth potential. I can assure you that the Board is committed to vigorously enforcing fair housing laws."

If your bank doesn't have such a position statement on discrimination, adopt one. If it does have such a statement, tout it. Send it to your employees and your customers. Advertise it in the bank's lobby and in statement stuffers. Get out the message that discrimination has no part in your organization. Establishing an antidiscrimination policy in the minds of every employee and customer will set the framework for a program in which discrimination is not tolerated.

As a corollary to this, you have to educate your employees. Overt discrimination is easy to find. But that is the rarity. Today's challenge is to find the more subtle forms of discrimination, which include the treatment of some customers slightly differently than others. That type of discrimination is much more difficult to uncover.

If confronted, most of us would state that we do not harbor biases about certain races or income groups. While we may genuinely think this is the case, we may unconsciously treat some individuals with more respect, courtesy, or even offers of help than others. Providing sensitivity training may be an answer if that is the case. That special training may help attune employees to cultural differences and unconscious behavior patterns. Sensitivity training, then, is another means of

providing a statement that discrimination will not be tolerated. I know of one large bank that recently provided sensitivity training to over 600 employees as part of its CRA program. Increasing employee awareness of cultural differences, especially those employees with public contact, will demonstrate your bank's concern.

I think it goes without saying that all financial institutions should review their loan policies to make sure that they are free from bias against any particular racial group. I believe that area is one you should look at, but one I'm not going to dwell on. But, after you assure yourself that your loan policies are without bias, you should look at how those policies are working in practice to satisfy yourself that they do not result in unjustifiable disparities in treatment among your customers and potential customers. One place to start is your bank's HMDA data. The data will tell you where and to whom you are lending. It will also enable you, in a very rough way, to compare how your bank is treating similarly situated applicants.

Reviewing HMDA data periodically will help ensure that your bank is kept abreast of how new products or changes in advertising and outreach efforts effect your mortgage lending. If a change in advertising triggers a corresponding increase in lending, it will show up in your periodic HMDA reviews. Likewise, if a new product does not generate new loans, the data will reflect this as well. Learning about a problem early will

allow you to correct for it and improve your lending performance during the year. And always, keep top management and board members abreast of what the HMDA reviews are telling you.

When you look at where your loans are made, compare your loan distribution with your bank's community delineation. Are any areas underserved? Are any areas excluded? If segments of your community are being left out, find out why. Figure out what you can do to ensure that these areas receive credit. Is there an advertising problem? Are credit products advertised in media which reach all segments of the bank's market? Or are credit products marketed in media that reach only a portion of the market?

When you find weaknesses in the data, take action to improve the profile. Long term sustainable solutions are best, but the results may take time to materialize. Be patient. If you have not served some markets, it may take time to become a familiar player. Successful business development efforts don't happen overnight as all bankers know. For example, suppose you decide to offer a new loan product to attract low- and moderate-income or minority individuals. Once you decide to offer a new product, target your marketing effort. Establish a dialog with community groups, particularly those in the minority community, and let them know about the new product. Don't rely entirely on the media. Get out there and talk to people and press the flesh.

The HMDA data will help you determine whether your bank is

offering credit to applicants without regard to race. But, you will have to do a lot of work beyond the data itself. Here's what I mean.

The HMDA data show who is applying for mortgage and home improvement loans and who is, and is not, getting them. If you receive few loan applications, you need to find out why. Is it an advertising problem? Is it an outreach problem? Does the bank need to focus more outreach efforts to solve the problem? Or is the low application rate from minorities or others an indication of discrimination in the prescreening process? Receiving few loan applications from minority applicants may indicate that the bank is discouraging applications, or reflect some other problem. For example, some applicants may feel intimidated by the bank or the application process itself. If this is the case, working with or through community or other organizations may increase applications from the targeted group.

In many cases, the quality of a marketing effort is more important than the quantity. If your bank is spending money for minority or low-income advertising programs, but is not receiving applications, then there may be another problem at work. You may have advertising that does not reach or appeal to the group you're aiming at. Does your advertising reflect the community you are targeting? Are all of the faces on your advertisements white, or do they represent the cultural diversity of the community? Do you need the assistance of a community group to

help target your marketing effort? Some banks have found it beneficial to work with community groups, such as a church group or other community organization, to promote a particular loan program.

If minorities are not applying for special programs, maybe the programs don't fit their needs. I recently heard of a bank that had expanded its advertising budget in an attempt to attract more minority applicants to a new home improvement product. Despite these budgeted increases, however, no new loan customers appeared. After consulting with a community group, the bank discovered that its minimum loan amount was too high. In short, it did not meet the credit needs of the group targeted.

Another area for investigation is credit underwriting standards. As part of your review, you should examine specific underwriting policies for requirements that may be unrelated to risk or repayment performance. Sometimes these standards may unduly effect a certain segment of the community.

No one advocates lenders sacrificing safety and soundness, in their pursuit of low-income and minority lending. However, when a mortgage underwriting standard is explained as "we've always done it this way," it shouldn't be surprising that some people will ask lenders, "couldn't there be another way of looking at it?" Today there are many innovative and successful lending programs that reflect new and different underwriting standards.

Test policies and practices by saying, "How does this underwriting standard help me evaluate risk? Is there an alternative that will achieve the same result?" For example, how is the applicant's credit history evaluated? What payments do you look at? Credit reports may not show payment histories that are important to many. For example, credit reports do not typically include rent and utility payments, which can be used as an indication of an applicant's ability and willingness to support a mortgage.

How do you evaluate an applicant with numerous job changes? Are there different criteria which predict creditworthiness and allow individuals to obtain a home? Minimum standards for the size or age of a house, off street parking or the number of bedrooms may exclude residents from urban communities with older homes from the mortgage market. But those factors may be of little significance to the soundness of the loan.

As a double check on credit process and underwriting standards, you might consider having a second or a management review of the bank's loan denials. This second review is another way to ensure that all applicants get at least an even chance at obtaining credit. For example, in some banks, a senior loan official or group of officials conduct a second review of all denied loan applications. This review checks for unfair treatment of applicants and also whether any loans could be made using different loan criteria or if the loans were structured

slightly differently. Sometimes, the second review results in a loan origination. In one of the most successful programs of this type, the reviewing officer is a minority female, and over time the new loans put on as a result of her review have had negligible losses.

While not a method for detecting discrimination, participation in mortgage review boards demonstrates a bank's willingness to "go the extra mile" to give a potential homeowner a second chance. For these boards, representatives from a group of banks gather to review denied mortgage applications. Each bank accepts a few of the denied loans when the review shows that the loans can be made. Participation on mortgage review boards and the use of committees to review internally denied loans makes a positive statement about the bank's commitment to the community. Loan experience gained from this participation may indicate ways in which the bank's underwriting standards could be adjusted to attract more creditworthy minorities.

You can also look at the HMDA data to satisfy yourself that you give all applicants an equal chance to qualify for credit. As you know, when the 1990 HMDA data was released, it showed disparities between white and minority applicants nationwide. Last October, the Federal Reserve Bank of Boston released a study based on mortgage lending in Boston which focused on that data. The study showed that black and Hispanic applicants were denied loans two to three times as often as their white counterparts.

To augment the HMDA data, the Federal Reserve Bank launched an expansive review of the specific data behind these loans, and focused on additional information contained in the loan files, but not in the HMDA data, for the entire Boston market.

The results were disheartening. The study found that individuals with no credit blemishes received credit, no matter what their color. But, few of the applicants were perfect. Most of the loan applicants had some credit problem which could have been used to deny the loan. And the study found that "for the same imperfections whites seem to enjoy a general presumption of creditworthiness that black and Hispanic applicants do not, and that lenders seem to be more willing to overlook flaws for white applicants than for minority applicants."

For example, a white applicant may have been given the chance to explain a credit problem, while a minority applicant may not. Or, a white applicant may have been steered to a different type of loan, or asked to put down a larger percentage in order to qualify for the loan where a minority applicant was not.

The Boston study points up the need to look at how your bank handles credit applicants. What kind of "coaching" do loan officers initiate? How are applicants with less than perfect credit records treated? Are procedures written? Do all applicable staff understand them? If procedures are unwritten, this may be the time to put them in writing. The goal is

evenhanded treatment for all applicants. To ensure this treatment for all applicants, consider giving your loan officers a script to use for potential customers. Mandatory coaching for all denied applicants may help many to qualify.

If you think there is a possibility of uneven treatment, alert top management and the Board of Directors. Tell management and the Board your findings and recommendations. Disparity in applicant treatment is apparently not uncommon, despite the existence of fair lending laws. Assuring identical treatment for all applicants should improve results.

The Federal Reserve Board has a Consumer Advisory Council composed of members from the banking industry, academia, and consumer groups. At last year's March meeting, several of the consumer representatives related stories about subtle, but inconsistent treatment between minority and white testers shopping for credit. The differences ranged from a black female not even being asked to sit down for a loan interview to a loan officer telling the applicant that the bank did not offer credit for mortgages under \$40,000 and to "try the bank down the street", even though this type of credit was included on the institution's CRA statement. The subtle differences of treatment of applicants cited in the Consumer Advisory Council testimony and the findings of the Boston study support the need for banks to examine their treatment of all applicants.

Along these lines, one approach that I support is the use of

credit "shoppers". Your board may want to consider authorizing the use of "shoppers" to visit various branch offices posing as mortgage applicants to test the bank's actual credit practices. Different treatment of similar applicants is cause for concern. If your credit shoppers are treated differently for no apparent reason, it is a red flag. Is it racial? Is the practice widespread, or limited to one office. Does the treatment reflect the bank's policy? What remedies can the bank prescribe for correcting the difference in treatment? Report the detailed findings to your Board. They need to know and to be part of the solution.

Later in this conference, someone from the Department of Justice will speak on the Decatur Federal case, but I thought I would offer some thoughts on it also. Decatur Federal is a savings and loan headquartered in Atlanta and one of the largest home mortgage lenders in that area. In the fall of 1992, the Department of Justice issued a consent decree against Decatur Federal, charging the S&L with discriminating against black homebuyers. This order is the first of its kind issued against a savings and loan, or any financial institution, for that matter.

Although Decatur Federal had received satisfactory CRA examinations and had never been accused of discriminatory practices, disparities in HMDA lending patterns triggered the Justice Department's review. A team from Justice entered Decatur in 1991 and reviewed mortgage loan applications which were

rejected between January of 1988 and May of 1992. From its in depth review, Justice concluded that Decatur had "engaged in a pattern or practice of discriminating against prospective black homebuyers." Contributing to this case were the facts that the bank:

- excluded sections of Atlanta inhabited by black residents in its community delineation;
- made no HMDA loans to black individuals;
- closed branches when black populations reached 85 percent and opened new branches in white neighborhoods;
- excluded black advertising media directed toward the black community;
- subjected black applicants to stricter loan standards than white applicants; and
- rejected black applicants at a higher rate than white applicants.

The Justice Department's consent decree requires that the savings and loan not only pay \$1 million in damages to those discriminated against, but also take steps to correct the deficiencies I mentioned. The work done by the Justice Department was intense and time consuming. As part of this investigation, Justice reviewed credit files and compared white accepted applicants with black rejected applicants. Altogether, it took the Justice Department three years to investigate. As an outgrowth of that experience, Justice now has proven

investigative procedures to use in other institutions.

This gets me to my point. The Justice review of Decatur was the first of its kind. Further reviews are planned. You may have heard about the "200 bank list." This is a list that Justice compiled based on denial rates and low minority applications volume noted in HMDA data.

To date, there has been no decision on which or how many of these institutions will receive a "Decatur" type investigation. Knowing that Justice, as well as community groups and other banks, are looking at your HMDA data should be an incentive for you to look at it first, determine which areas need additional study, and correct the deficiencies noted. No one here believes that having the Justice Department investigate a bank is the most effective, or least costly way to root out discrimination in the industry. The most effective way is to have individual banks find and eliminate problems within their own institutions. And I want to say here, that from a management perspective, the steps you take to address these issues should be no different from other actions that you are currently taking to ensure that your bank's other strategies and plans are being carried out in an effective and profitable manner.

In closing, I'd like to say that loan customers of all colors are valuable to every financial institution, especially today. To find and eliminate possible discrimination, you first have to take a stand against it. You have to let your employees

and customers know that it will not be tolerated in your organization. You have to set the framework so that everyone within your institution and everyone who comes in contact with it knows that you are a fair and equitable lender.

Discrimination is illegal and morally repugnant. It is also bad business. It robs the individual of his dignity, to say nothing of his chance to own his own home. It also robs the bank of a chance to make a loan and a profit. And who among you is not interested in adding to the bottom line? I urge all of you to look hard at your bank and eliminate any and all mortgage lending discrimination. Thank you.